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NO. 85-592

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

BRIEF OF AMERICAN GAS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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INTEREST OF THE *AMICUS CURIAE*

The American Gas Association (A.G.A.) is a national association representing the interests of approximately 300 member companies involved in the distribution and transmission of natural gas throughout the 50 states. Our member companies account for approximately 85 percent of all domestic regulated gas industry sales. The Natural Gas Pipeline Company of America (Natural), petitioner in this case, is a member of the A.G.A.

This case involves review of a decision of the U.S. Court of Appeals for the District of Columbia Circuit, affirming orders of the Federal Energy Regulatory Commission (Commission or FERC), denying Natural the recovery from rates of certain abandoned project costs. Natural was denied recovery of its out-of-pocket investment costs for three nontraditional gas supply projects. They include costs associated with a coal gasification project,[1] a liquefied natural gas (LNG) project

[1] Also referred to as a synthetic natural gas or SNG project.

and an effort aimed at transporting gas from Alaska to the lower 48 states.

These projects arose in the 1970s, a period of acute supply shortage for Natural and for the natural gas industry. Natural entered into these supply projects because they presented an opportunity to obtain significant gas supplies for the future. The investments were made when the deliverability of Natural's traditional supplies was insufficient to meet the pipeline's requirements. The deliverability of traditional gas supplies was also expected to decline even further. It is not disputed that Natural needed the additional supplies to serve its gas customers.

The Court of Appeals affirmance of the Commission's ruling is of vital interest to A.G.A. and its membership. In denying the recovery from rates of prudently incurred costs for abandoned supply projects, precedent is established which injures the entire natural gas industry. In addition, the failure to indicate any reasoned basis for treating failed gas supply projects differently from other types of supply projects is especially troublesome. The decision presents questions of major importance warranting review by this Court.

The natural gas industry is damaged in four major ways by the challenged decision and orders:

First, by disallowing even prudent investment costs for abandoned supply projects, the decision has a chilling effect on all industry efforts to develop new gas supplies. At a time when natural gas accounts for over 24 percent[2] of our domestic energy needs and demand is increasing by approximately 4 percent[3] a year, the development of new gas supplies is of vital importance to the nation, gas consumers and the gas industry. The holding below substantially reduces the incentives for pipelines and others to attempt to develop new supplies.

Second, the decision undermines the gas industry's efforts to compete with the providers of alternate fuels. As discussed

[2] American Gas Association, *Gas Facts: A Statistical Record of the Gas Utility Industry* 127 (1984).

[3] *Id.* Reflects the approximate increase from 1983 to 1984.

herein, the FERC has permitted electric companies to recover their "dry-hole" costs in rates. The oil industry is unregulated and thus may also include the cost of unsuccessful supply projects in prices. By requiring gas companies to charge all such costs to shareholders, gas companies face greater financial risk, increased difficulty in attracting capital and a resulting disadvantage in competing with alternate fuels.

Third, the decision is inconsistent with one of the Commission's major responsibilities. Under the Natural Gas Act, the Commission must assure an adequate gas supply for consumers. See e.g., *F.P.C.* v. *Texaco Inc.*, 417 U.S. 380, 388 (1974). The decision provides a substantial disincentive for pipelines and others to develop adequate gas supplies for their markets. This is inconsistent with the Commission's obligations and, over time, threatens gas consumers.

Fourth the decision threatens the financial health of gas companies. Pipelines and distributors are charged with the responsibility to serve customer gas requirements but are denied cost recovery when they prudently incur expenses to develop gas supplies. It is fundamentally unsound for the FERC to impose service requirements on pipelines and then apply a financial penalty when they attempt to develop necessary gas supplies. This is particularly damaging when, as here, traditional suppliers were unable to fulfill the company's gas requirements.

In light of the importance of the issues presented, and the gravity of the harm to the industry from the Court of Appeals and FERC decision, A.G.A. files this *amicus curiae* brief in support of the petition for a writ of certiorari filed by Natural.

SUMMARY OF ARGUMENT

The Court of Appeals decision, affirming the Commission order, presents at least two major issues of importance to the gas industry and to the supply security of this nation.

First, by denying recovery of the prudently incurred out-of-pocket costs for abandoned gas supply projects needed to satisfy customer requirements, only the immediate financial

interests of consumers are advanced. This Court has long held that in establishing just and reasonable rates the Commission must balance the interests of consumers and gas companies. The Court of Appeals and Commission have departed, without cogent reasoning, from prior holdings which adopted the very balancing of interests advocated by Natural.

Second, the challenged decisions establish inconsistent rate treatment for abandoned projects. Although the Commission and appellate court have permitted cost recovery for failed electric generating projects, unsuccessful gas exploration and gas storage facilities, they have denied recovery for nontraditional gas supply projects. No factual or statutory differences justify this inconsistent treatment. This inconsistent rate treatment financially damages gas companies, adversely affects the development of nontraditional gas supply projects and undermines the industry's ability to fulfill gas service obligations.

ARGUMENT

1. BY REFUSING TO ALLOW THE RECOVERY OF PRUDENTLY INCURRED EXPENSES, THE COURT OF APPEALS DECISION, AFFIRMING THE FEDERAL ENERGY REGULATORY COMMISSION ORDER, JEOPARDIZES THE FINANCIAL INTEGRITY OF GAS COMPANIES AND VIOLATES THEIR RIGHT TO RECOVER THEIR REASONABLE COSTS.

For over forty years, this Court has explicitly held that the obligation of the Commission in establishing "just and reasonable" rates is to balance the interests of gas consumers and gas companies. This balancing requires that the Commission protect consumers against exploitation while promoting the financial integrity of natural gas companies. Thus, in reviewing a Commission order from the perspective of the gas company, "the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the

risks they have assumed." *Permian Basin Area Rate Case*, 390 U.S. 747, 791-792 (1968); *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

This standard was applied in *F.P.C.* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 474 (1973), to overturn a Court of Appeals decision which looked only to the question of consumer benefit. The appellate court's holding, "that the consumer interests were not furthered", fell short of the application of the appropriate standard for review. By looking only to whether the consumer interest was furthered, the appellate court had failed to consider the financial health of the pipeline.

In this case, the prudently incurred gas supply project costs of a pipeline were excluded from rates because it was found that the failed projects were not "used or useful" to consumers. By looking only to the usefulness of the immediate project, and not to the prudency of investments necessary to assure adequate gas supply, the Court of Appeals only considered whether the immediate consumer interest was furthered. The decision reflected no consideration of the need for investment in gas supply projects. It also failed to consider the financial harm to pipelines and their shareholders from applying such a narrow test. As in *Memphis Light*, this falls short of the standard established by this Court.

The essence of the requirement that rate orders must be reasonably expected to maintain financial integrity, attract capital and compensate investors for risk is that gas companies are entitled to recover their costs when they act reasonably and make prudent investment decisions. If rate decisions are based only on whether the result of an investment was a useable project, and the pipeline is denied recovery for all "dry hole" expenses, there is no balancing of risks and benefits. There is no balance of interests if when a supply project is successful the consumer benefits by receiving power but when there is a "dry hole" they do not bear the cost and are thereby insulated from the financial consequences.

The consumer interest is protected by the requirement that companies can only recover their costs when their investment decisions are reasonable and prudent. The proposal by

Natural that it only recover the out-of-pocket costs for the terminated projects, gave weight to both consumer and pipeline interests. The proposal permitted recovery of costs but did not seek any return on the investment for the abandoned project.

Prior commission decisions have acknowledged the need for consumer rates to reflect the full cost of providing service. As the Commission stated in *Phillips Petroleum Company*, 24 F.P.C. 537, 559 (1960):

> The gas consumer must pay rates sufficient, amont other things, not only to amortize the cost of successful past drilling which makes present service possible, but also the current losses and other expenditures incurred in an attempt to replace the gas currently being produced and consumed and continue service in the future.

This reflects the mutual interests of gas consumers and gas companies in developing and replacing gas supplies. The policy considerations reflected in this opinion apply with equal force to a pipeline which develops its own supplies as it does with the traditional gas producer.

It is also financially unrealistic to expect investors to assume the risk of loss for the many supply projects which gas companies must invest in to provide reliable service to their customers. Investors are only compensated by a return on invested capital. A rate of return adequate to compensate investors for the risk of large, capital write-offs for unsuccessful supply projects, would need to be at unprecedented levels. The resulting higher rates would act to the long-term detriment of consumers and gas companies.

In a case directly analagous to the one at issue, the Commission interpreted the "used and useful" standard to distinguish its application from the situation presented here. *New England Power Co.*, 8 FERC ¶ 61,054 (1981). The "used and useful" standard was applied to deny the inclusion in rate base of plants which were cancelled. The standard did not bar recovery from rates of the actual costs incurred from the failed

projects. Thus, as in this case, where the company only seeks cost recovery, rather than a return on investment, the "used and useful" standard is inapplicable.

In *New England Power*, the Commission allowed a company to amortize over a five-year period its losses on a cancelled oil-fired electric generating unit. Although the administrative law judge had found the expenditures to be of a preliminary nature, the Commission permitted recovery because it found no evidence that the investment was imprudent or the costs unreasonable. The Commission explained that the "used and useful" standard justified excluding the costs from rate base. The Commission stated there was "no precedent" for "requiring ratepayers to pay a return on an expenditure that has not resulted in productive plant that is used or useful in the public service." 8 FERC ¶¶ 61,054, 61,175. It was not disputed, however, that because the investment was prudent when made, the company was entitled to recover the costs incurred. This result was found by the Commission to be an "equitable balance between the interests of investors and ratepayers." 8 FERC ¶¶ 61,054, 61,175.

In affirming the Commission's decision, the Court of Appeals also held this to be the appropriate balancing of interests between consumers and companies. As it explained:

> Because it would be inequitable to place on the utility the entire loss of expenditures prudent when made, FERC allowed recovery thereof over time. At the same time, FERC is charged with a duty to protect the consumer against unreasonably high rates. Far from an inconsistency, FERC here struck a reasonable balance between the interests of investors and ratepayers.

NEPCO Municipal Rate Committee v. *FERC*, 668 F.2d 1327 (D.C. Cir. 1981).

No reasoned analysis supports the Commission and appellate court's departure in this proceeding from the balancing of interests established in the *New England Power* decisions. They adequately reflected the established principles of this Court.

2. THE CHALLENGED DECISION ERRS IN ESTABLISHING INCONSISTENT RATE TREATMENT FOR ABANDONED PROJECT COSTS AND REPRESENTS A HOSTILITY TO THE DEVELOPMENT OF NONTRADITIONAL GAS SUPPLIES

The Court of Appeals decision, affirming the FERC order, establishes inconsistent and discriminatory rate treatment for abandoned gas supply project costs. The distinctions in treatment are based on the type of energy provided or whether the party involved is a pipeline or a traditional gas producer. In addition, contrary to the facts and without any support in the record, the court brands all LNG and SNG projects as "exotic", "unproven" and "radically different from orthodox methods". App. 35a. This is provided as support for the inconsistent treatment of costs from such projects. This action is inconsistent with FERC's obligation to act in a consistent and even-handed manner in deciding similar issues on different pipelines. *Michigan Wisconsin Pipe Line Co.* v. *FPC*, 520 F.2d 84, 89 (D.C. Cir. 1975); *American Public Gas Association* v. *FPC*, 546 F.2d 983, 988 (D.C. Cir. 1976).

The Commission has repeatedly allowed recovery of expenses incurred by companies in unsuccessful projects undertaken to supplement or improve service. The Commission has allowed recovery for unsuccessful gas storage projects. *Southern Natural Gas Co.*, 29 FPC 323 (1963); *Midwestern Gas Transmission Co.*, 32 FPC 993 (1964). In *Tennessee Gas Pipeline* v. *FERC*, 606 F.2d 1094 (D.C. Cir. 1979), the Court of Appeals discussed and approved of exceptions to the "used and useful" requirement for including storage project costs in rates. Similarly, the FERC has allowed recovery of unsuccessful gas exploration costs by producers and pipelines. *Phillips Petroleum Co.*, 24 FPC 537 (1960), affd. *Wisconsin* v. *FPC*, 303 F.2d 380 (D.C. Cir. 1961), affd. 373 U.S. 294 (1963); *Panhandle Eastern Pipe Line Co.*, 25 FPC 787 (1961). Finally, the Commission has permitted electric utilities to amortize prudently incurred expenses from unsuccessful generation projects through the cost of service. *New England Power Co.*, 8 FERC ¶ 61,054 (1979), affd. *NEPCO Municipal Rate Comm.* v. *FERC*, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982).

Although the "used and useful" concept has been utilized by FERC to deny recovery of abandoned supply project expenses, it has often been disregarded for traditional gas and electric projects. The FERC has only been consistent in denying cost recovery from LNG, SNG and other nontraditional gas supply projects.

No rationale exists for the inconsistent treatment accorded Natural's abandoned supply projects. As with the failed projects where cost recovery has been allowed, Natural entered into the projects to meet its customer's gas requirements. The projects were expected to provide significant quantities of gas, over the long term, to assure continued service to customers. The Court of Appeals offers three major reasons for treating Natural's project costs differently. None of these reasons withstand scrutiny.

First, the Court of Appeals offers that the statutory schemes governing electric and natural gas utilities vary somewhat and thus different treatment of electric and gas project costs is justified. This Court has held that comparable provisions of the Federal Power Act and the Natural Gas Act "are in all material respects substantially identical." *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571, 577 n.7 (1981); *F.P.C.* v. *Sierra Pacific Power Company*, 350 U.S. 348, 353 (1956). Sections 205 and 206 of the Federal Power Act, 16 U.S.C. § § 824d and 824e, are substantially the same as Section 4(e) and 5(a) of the Natural Gas Act, 15 U.S.C. § § 717c and 717d. There is no statutory distinction which would warrant different regulatory treatment.

Second, the appellate court cites the certificate requirement for gas companies as support for the inconsistent treatment of gas and electric supply projects. The FERC has no certificate authority over the production or gathering of natural gas. The fact that the Commission does have certificate authority over pipeline facilities, but not over electric activities, is simply irrelevant to the separate issue of cost recovery. The central issue to cost recovery is whether the costs were prudently incurred. In determining whether to permit recovery of failed project costs, the Commission is as free to accord electric

generation expenditures the same degree of scrutiny as in a gas certificate case. This "after the fact" inquiry should enhance, rather than diminish, the Commission's ability to review supply project costs.

Finally, the decision distinguishes recovery for failed gas storage projects by characterizing them as "the normal activity of a pipeline seeking to maintain its physical plant and equipment". App. 28a. We submit that storage has nothing to do with maintaining pipeline equipment. Both the supply projects at issue and gas storage projects are efforts by pipelines to enhance the availability of gas supply. They both supplement system gas supplies. They are also reviewed under the same statutory standards. There is no factual or statutory distinction which justifies the different treatment accorded the projects at issue from failed gas storage projects.

One explanation for the inconsistent rate treatment accorded Natural's projects is an unjustified hostility to nontraditional gas supply projects. No evidence or findings in this case support the court's characterization that these technologies are "exotic" and "unproven". App. 35a. Far from being experimental or unproven, many LNG and SNG facilities are currently in operation providing reliable and cost-effective service to consumers.

There are currently thirteen operational SNG from liquid hydrocarbon facilities in the United States. Several have provided needed gas to the greater Washington, D.C. area for many years. SNG facilities have produced over 1.5 trillion cubic feet of gas since 1976. A number of plants have been in operation since the early 1970s. The technology is well understood and the operational experience is broadly available. Additional research and development work is now underway to improve the processes and not to validate the technology. As such, SNG from liquid hydrocarbons is based on a mature technology.[4]

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[4] American Gas Association, *Status of SNG-from-Liquid Hydrocarbon Plants*, Gas Energy Review, Aug. 1985 at 17.

The SNG technology needed to manufacture significant amounts of pipeline quality gas from coal is also readily available. This technology has been used commercially outside of the United States for many years. By the late 1970s the gas industry had already invested over $130 million to develop commercial-scale coal gasification projects in this country. It has been regulatory delay and financing constraints rather than technological uncertainty which has slowed the commercial use of coal gasification in this country. Because coal gas can use the nation's vast coal reserves in an efficient and environmentally sound manner, it has long been considered one of the most attractive supplemental sources of gas energy.[5]

Similarly, LNG is also a mature technology providing substantial quantities of cost-effective gas to consumers. The basic technology required to support an expanded LNG export and import industry has been operational for over 20 years. There are currently over 100 LNG peak-shaving and base-load plants in operation worlwide. In addition, in 1978 there were over 11 operating LNG trade projects, with annual deliveries of approximately 1.6 trillion cubic feet of gas per year.[6] Many cities throughout the United States depend on LNG to provide essential peak period energy and to supplement base-load supplies. LNG facilities are neither exotic nor unproven.

The Court of Appeals has not applied any reasoned analysis or rationale for the inconsistent rate treatment accorded Natural's abandoned projects. This inconsistent treatment financially injures Natural and has an unwarranted, chilling effect on the development of LNG, SNG and other nontraditional gas supply projects.

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[5] American Gas Association, *Fact Book: Synthetic Pipeline Gas From Coal*, Sept. 1979.

[6] Sarkes, Iribe and Smith, *LNG: Current Status Confirms Its Technical Maturity*, Pipeline and Gas Journal, Nov. 1978.

CONCLUSION

For the forgoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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